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In The

Supreme Court of the United States

DAVID A. and LOUISE A. GITLITZ;
PHILIP D. and ELEANOR G. WINN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Tenth Circuit

REPLY BRIEF

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I. ADDITIONAL REASONS FOR GRANTING THE WRIT

The Taxpayers and the Government agree that the number of cases pending both in the courts and before the IRS makes resolution of the issue presented in this case a matter of considerable national importance. The issue may also affect a vast number of taxpayers. In 1999, almost 2.7 million S corporation returns were filed.[1] While only a fraction of these S corporations receive cancellation of debt income when they are insolvent, the issue effects thousands of S corporations' shareholders.

II. REPLY TO NEW ARGUMENT IN THE GOVERNMENT'S RESPONSE.

Although the Government acquiesced in Taxpayers' Petition, it makes an argument that was not presented below. Taxpayers file this Reply in order to address this new argument.

A. The Government's Contention That Excluded COD Income Is Not An "Item Of Income" Is Incorrect.

Rather than defending the Tenth Circuit's opinion, the Government makes an argument that was not presented to the Court of Appeals, taking the position that cancellation of debt ("COD") income excluded from tax under 26 U.S.C. § 108(a)(1)(B)[2] does not constitute an

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[1] Zaffino, Frank "Projections of Returns to Be Filed in Calendar Years 2000-2006" This article was posted on March 9, 2000 at the IRS web site as 06RSOIPR.exe at *http://www.irs.gov/tax_stats/soi/other_pr.html.*

[2] All statutory citations, unless otherwise specified, refer to Title 26. Cites to Regulations or Treasury Regulations likewise refer to 26 C.F.R. References to the "Code" refer to the Internal Revenue Code of 1986, Title 26.

"item of income" for purposes of the S corporation shareholder basis rules of §§ 1366 and 1367.

The operative language of § 108(a)(1)(B), like every other exclusion from gross income in the Code (§§ 101-138), utilizes the phrase "gross income shall not include. . . . " Thus, an insolvent taxpayer's COD income is removed from taxable income in the same way as municipal bond interest (§ 103) and life insurance proceeds (§ 101).[3] Section 1366, however, is not limited in its operation to items of income that are included in gross income; section 1366(a)(1)(A) requires that S corporation shareholders take into account their pro rata share of, "items of income ***(including tax-exempt income)***, loss, deduction, or credit the separate treatment of which ***could affect*** the liability for tax of any shareholder." (Emphasis supplied). Thus, the statute specifically includes "tax exempt income," as well as all other income that "could affect" shareholder tax liability, in the basis calculation process. It is then necessary to ask whether COD income of an S corporation is either a species or "tax-exempt" income, or whether it "could affect" the tax liability of any shareholder. The answer to both queries is yes.

1. Excluded COD Income Is "Tax-Exempt" Income.

Citing the Tax Court's opinion in *Nelson v. Commissioner*, 110 T.C. 114, 125 (1998), the Government argues that COD income is not "tax-exempt," but rather "tax-deferred," because it is not "exempt on a permanent basis." Brief for the Respondent, p.14. The Government's rationale is that the correlative attribute reduction

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[3] The Government concedes that income excluded under these two sections of the Code are "items of income" for purposes of the basis adjustments required by §§ 1366 and 1367. Brief for the Respondent, p.15.

scheme set out in § 108(b) makes this statute better characterized as achieving deferral, rather than true exemption from income.[4]

The "tax-deferred" category does not withstand close scrutiny for several reasons. First, and foremost, this category is not supported by any statutory language. Similarly, there is no statutory basis for the Tax Court's "permanence" requirement.

Second, while COD income ***might*** be indirectly linked to a correlative increase in taxable income of a later year as a result of attribute reduction, this fact provides no basis for treating COD income as anything other than "tax-exempt" in the current year. A COD income item is realized in the current year, and that item (*qua* item) is ***never*** realized in any future year. As a result of the exclusion of COD, an attribute, such as basis in a depreciable asset, may be reduced. *See* § 108(b)(2)(E). That reduction may, in turn, cause an increase to future

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[4] In support of the "tax-deferred" argument, the Government cites *United States v. Centennial Savings Bank*, 499 U.S. 573 (1991), in which this Court, in dictum unimportant to any holding in the case, characterized the operation of the "qualified business indebtedness" exclusion of Former § 108(a)(1)(C) as "deferring" tax on income. The "qualified business indebtedness" provision allowed an exclusion, even when the taxpayer was not insolvent or in bankruptcy, if the taxpayer affirmatively "***elects*** to reduce the basis of his depreciable property by an amount equal to the income excluded." 499 U.S. at 580. To be eligible for the "qualified business indebtedness" exclusion, it was necessary that there be complete symmetry between the amount excluded and the correlative consequence. As explained below, under the insolvency exemption, there is no direct tie between exclusion and the amount of attribute reduction in many cases. To claim that a brief characterization (in dicta) of the "qualified business indebtedness" exclusion is controlling for the insolvency exemption, and, moreover, establishes a new class of income ("tax-deferred") that is not referred to anywhere in the Internal Revenue Code, is specious.

year's income subject to tax by reducing depreciation deductions. But it does not cause the item of income excluded in the current year – the COD income – to be taxed in any future year.

Third, the Government's contention, that income exempt under § 108(a)(1)(B) is not permanently exempt because of attribute reduction, ignores the fact that many taxpayers either (1) have no tax attributes to reduce, (2) have COD income in excess of their tax attributes, or (3) have attributes to reduce, but the reduction never results in income recognition. *See Farley v. United States*, 202 F.3d 198, 210 (3d Cir. 2000) (government concedes COD income is sometimes tax exempt). In these instances, the § 108 exclusion will never result in any offsetting increase in tax on future years' income. Such amounts of income will ***never*** be included in taxable income and therefore, even under the *Nelson* court's "permanence" standard, are "tax-exempt."

Fourth, the Treasury Regulations promulgated in 1992 (following the year at issue in this case), and effective until revised during the course of this litigation, provided:

> [A basis] adjustment for a nontaxable item is determined for the taxable year in which the item would have been includable or deductible under the corporation's method of accounting for federal income tax purposes if the item had been subject to federal income taxation.

Treas.Reg. § 1.1367-1(d)(2) (withdrawn 1999). Under this regulation, if an item of income were "includable" in the current year's income under the corporation's method of accounting, but not subject to federal income taxation ***during that year***, it is a "nontaxable item," and the shareholder is required to increase basis by that amount. COD income was realized and would have been includable in gross income in the year of receipt under the corporation's method of accounting had the COD income been subject to tax. The COD income item (*qua* item) will never be taken into account in any future year.

In addition, while the Government seeks to differentiate income excluded under § 108 from other exclusions under Part III of Subtitle A of the Code (Brief for the Respondent, p.15), prior usage of the term "exempt" in the Internal Revenue Code and in Treasury Regulations belies this distinction.

In this respect, § 139 uses the term "exemption" as a generic description of the exclusions in Part III (§§ 101-139). Section 139 is a cross-reference statute whose operative language provides that "for ***exemption*** of" certain items from income, a designated section of another Title should be consulted.[5] Congress thus considered the statutes found in Part III to be, as a group, "exemptions" from tax, and, indeed, used the term "exemption" as a synonym for "exclusion."

In the regulations governing the allocation and apportionment of deductions to income earned domestically and from foreign sources, the Treasury has construed the phrase "exempt income" broadly to include all income which is "exempt, excluded or eliminated" for federal income tax purposes. Temp.Reg. § 1.861-8T(d)(2)(ii)(A). Treasury recognized that the ordinary, everyday meaning of the word "exempt" is "not subject to tax" and is synonymous with the term "excluded."

Even more compelling, the Consolidated Return Regulation governing parent basis in subsidiaries (which is similar to the rules for shareholder basis in S corporations) treats COD income as "tax exempt," rather than "tax-deferred." The operative provisions of the regulation treat substituted basis transactions (where recognition is deferred until the asset is sold at a later date), e.g., §§ 118, 332, 351 and 1031, as not "tax-exempt" because required basis adjustments prevent the non-recognition from being permanent. Treas.Reg. § 1.1502-32(b)(3)(ii)(A). However, COD income is explicitly characterized by the regulations

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[5] During the year at issue (1991), the identical cross-reference statute was found at § 136.

as a species of "tax-exempt income," to the extent that it is applied to reduce attributes. Treas.Reg. § 1.1502-32(b)(3)(ii)(C)(1). This is contrary to the position of the Government in this case, where the Government strenuously argues that the linked attribute reduction prevents the exclusion for COD income from being truly "tax-exempt."

Given this prior substantial characterization of all excluded income, including COD income, as "tax-exempt," the Government's attempt to manufacture a difference between "exclusion" and "exemption" linked to § 108 potential reduction of attributes must be rejected.

Finally, the IRS issued a technical advice memorandum indicating that when a partnership receives COD income, a partner's pro rata share of that income increases that partner's basis, irrespective of whether that income is taxable or tax-exempt to the partner and irrespective of the fact that attributes may be reduced because of the COD income inclusion. TAM 9739002.[6] The TAM quoted extensively from the legislative history of § 108 and concluded that income excluded from tax under § 108(a) *does* increase basis under § 705 (the partnership analogue of § 1367), even though attributes may be reduced.

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[6] While this ruling is not official precedent under § 6110(j)(3), private letter rulings may be cited for the purpose of providing evidence of the Commissioner's interpretation (*Cantebury v. Commissioner*, 99 T.C. 223, 247 (1992) (*quoting Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962))), insight into the Commissioner's understanding of complex tax issues (*Capitol Fed. S & L Assoc. v. Commissioner*, 96 T.C. 204, 223 (1991)), or evidence of confusion in the Commissioner's interpretation or a change in position. (*Spencer v. Commissioner*, 43 F.3d 226, 234 (6th Cir. 1995)).

2. Excluded COD Income "Could Affect" Shareholder Tax Liability.

The statutory test for whether an item of income is taken into account for purposes of adjusting shareholder's stock basis is whether it "could affect the liability for tax of any shareholder." In the case of an item that is recognized at the corporate level, a pro rata share of the item is included in the shareholder's gross income, and directly effects the tax liability of the shareholder. However, even with respect to items of income realized by the corporation but not recognized, there is still a potential impact upon an individual shareholder's tax liability. With respect to "tax-exempt income," e.g., state and local bond interest under § 103, the separate treatment of the exempt item does not increase gross income. Because income treated as "tax-exempt" at the corporate level will never be treated otherwise at the shareholder level, the meaning of the phrase "could affect the liability for tax of any shareholder" necessarily relates to an indirect or collateral consequence of "tax-exempt income."

When Congress enacted §§ 1366 and 1367, it understood that tax-exempt income realized by the S corporation would be passed through to the shareholders (retaining its exempt character) and increase the shareholders' basis in their stock: "Tax-exempt interest will pass through to the shareholders as such and will increase the shareholder's basis in their Subchapter S stock. Subsequent distributions will not result in taxation of the tax-exempt income." S. Rep. No. 97-640, 97th Cong., 2d Sess. 16 (1982), 1982-2 C.B. 718, 725.[7] The

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[7] This rationale for increasing shareholder basis is equally applicable to excluded COD income. In the case where an S corporation which is insolvent to the extent of $100 receives excluded COD income of $50, the corporation has received a benefit: rather than being insolvent to the extent of $100, it is now only insolvent to the extent of $50. At some point, the corporation may become solvent, and make distributions to its

parenthetical language contained in § 1366(a)(1)(A), specifically including "tax-exempt income" as income which may "affect" shareholder tax liability, can thus only mean that "tax-exempt" items are necessarily separately stated ***because*** of their effect on the shareholder's stock basis.

Just like tax-exempt interest, COD income is also a separately stated item of income under § 1366(a)(1)(A) because, although non-taxable, it has an effect upon basis (in the same manner as tax-exempt interest). However, unlike other nontaxable items, in the case of COD income, there is another means by which a shareholder's tax liability may be affected.

Under § 1366(d), where a shareholder's share of S corporation losses for any taxable year exceeds stock basis, the excess may not be deducted currently, but is "suspended" and carried to future periods. Section 108(d)(7)(B) provides that one of the attributes subject to reduction is shareholder losses suspended under § 1366(d). Shareholder's suspended losses are treated as if they were net operating losses ("NOLs"), the first item reduced pursuant to § 108(b) in the attribute reduction process. § 108(d)(7)(B). Suppose that an S corporation has two shareholders, A and B, whose ownership is A – 60% and B – 40%, and that these shareholders have losses suspended under § 1366(d)(1) in the amounts of A – $90 and B – $40. Now assume the corporation realizes $30 of excluded COD income. In the attribute reduction process, A would have his suspended losses reduced by $18 (60% of $30) to $72 and B would have his suspended losses reduced by $12 (40% of $30) to $28.

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shareholders. Then, unless there were a basis adjustment, the shareholders would be taxed upon that $50 difference ***in addition to*** any additional tax paid because of attribute reduction.

Clearly, COD income "may affect" the tax liability of shareholders: COD income may reduce shareholder-level suspended losses and result in an increase in the shareholders' subsequent year's taxes. Excluded COD income must then be taken into account by shareholders in the calculation of their stock basis.

B. The Government's Position Continues To Be A Moving Target.

While the Government's "item of income" argument was not raised in the Tenth Circuit, this argument is very similar to the Commissioner's argument before the Tax Court in the initial *Winn* case (*Winn v. Commissioner*, T.C.M. (RIA) 97,286). This argument was rejected by Judge Cohen in her initial opinion, and has not been raised subsequently in this litigation. The Commissioner moved for reconsideration in *Winn*, asking the Tax Court to consider alternative arguments. The initial *Winn* opinion was withdrawn and replaced by an opinion that followed the logic of those alternative arguments as adopted by the Tax Court in *Nelson*. *Winn v. Commissioner*, T.C.M. (RIA) 98,071, *aff'd sub nom., Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999).

On March 31, 2000, the Solicitor General acquiesced in our request for certiorari. On March 23, 2000, the Commissioner filed its Opening Brief in *Schmidt v. Commissioner*, Tax Court Dckt. No. 5505-99, attached as an Appendix to this Reply. Before this Court, the Government argues primarily that excluded COD income is not an "item of income." This argument is not found anywhere in the *Schmidt* brief. In contrast, in the Tax Court, the Commissioner relies extensively on the rationale presented in the *Nelson* opinion (by requiring exclusion "at the corporate level," § 108(d)(7)(A) precluded the §§ 1366 and 1367 pass through to shareholders). This argument appears nowhere in the Government's Brief in this Court. While the Government is free to pursue alternative arguments, the radical differences in position taken by the

government in briefs filed eight days apart, concerning an issue that has been the subject of significant litigation for more than three years, gives additional support to the Taxpayers' contention that the Government's arguments are based solely upon the result sought, and not upon the controlling statutory language.

RESPECTFULLY SUBMITTED this 26th day of April, 2000.

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APPENDIX

UNITED STATES TAX COURT

JAMES M. and SOPHIA L. SCHMIDT, Petitioners, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	Docket No. 5505-99

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UNITED STATES TAX COURT

JAMES M. and SOPHIA L. SCHMIDT, Petitioners,	)	Docket No. 5505-99
v.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

BRIEF FOR RESPONDENT

PRELIMINARY STATEMENT

This case involves a deficiency determination of $128,699 for the petitioners' 1994 taxable year.

This case was set for trial before the Honorable Robert P. Ruwe at the Seattle, WA, Trial Session beginning on February 7, 2000. At the calendar call, the case was submitted to the Court on a fully stipulated basis. The evidence consists of a Stipulation of facts (¶¶ 1-56) and attached exhibits (1-J through 7-J). The Court requested that the parties file simultaneous briefs. Opening briefs are due on March 23, 2000, and reply briefs are due on April 22, 2000.

The other issues raised by the notice of deficiency (i.e., the adjustments to itemized deductions and to the deduction for personal exemptions) are computational. Resolution of the principal issue will resolve these issues.

QUESTION PRESENTED

Whether discharge of indebtedness (COD) income excluded under I.R.C. § 108(a) from the gross income of an S corporation passes through to the S corporation's shareholders as an item of income under I.R.C. § 1366(a)(1)(A) and, in turn, increases the basis of the shareholders' corporate stock under I.R.C. § 1367.

RESPONDENT'S REQUEST FOR FINDINGS OF FACT

The respondent respectfully asks that the Court find the following evidentiary facts:

1. At the time their petition was filed, the petitioners' mailing address was 2 Grove Isle Drive, Unit 1208, Miami, Florida 33133-4112. (Stip. ¶ 1).

Experius Health Care, Inc. ($293,303 adjustment)

2. Petitioners owned 62.15% of Experius Health Care, Inc. (EHCI) in 1994. (Stip. ¶ 5).

3. EHCI was incorporated on 1/9/82. (Stip. ¶ 6).

4. At all relevant times, EHCI was an S corporation. (Stip. ¶ 8).

5. EHCI's primary activity involved the operation of a nursing home in Kansas City, Missouri. (Stip. ¶ 10).

6. EHCI ceased the foregoing operations in 1994. (Stip. ¶ 11).

7. As of 12/31/93, the petitioners had suspended ordinary losses (losses in excess of stock basis) attributable to EHCI in the amount of $488,086. (Stip. ¶ 12).

8. As of 12/31/93, the petitioners had suspended capital losses (losses in excess of stock basis) attributable to EHCI in the amount of $115,983. (Stip. ¶ 13).

9. As of 12/31/93, the petitioners had a zero stock basis in EHCI. (Stip. ¶ 14).

10. For 1994, the petitioners reported ordinary income from EHCI in the amount of $194,783. (Stip. ¶ 15).

11. In 1994, EHCI's and others debt of $2,234,705.44 to the FDIC was restructured and $1,108,385.02 was forgiven by the lender. (Stip. ¶ 17).

12. In 1994, EHCI and others realized $1,108,385.02 of COD income under the provisions of I.R.C. § 61(a)(12). EHCI's share of this COD income was $530,666.86. (Stip. ¶ 18).

13. The petitioners' pro rata share of the $530,666.86 (COD income) was $329,810. (Stip. ¶ 21).

14. At the time the $530,666.86 was realized by EHCI, it was insolvent by at least $530,666.86. (Stip. ¶ 19).

15. EHCI excluded the entire $530,666.86 of COD income from its gross income. (Stip. ¶ 20).

16. The petitioners claim to have increased their stock basis in EHCI in 1994 by the followng amounts:

Ordinary income flow-through:	$194,783
Pro rata share of income excluded under § 108 (i.e., of $530,666.86):	329,810
	$524,493

(Stip. ¶ 22).

17. In 1994, the petitioners deducted $488,086 of their suspended ordinary losses and $36,507 of their suspended capital losses ($488,086 + $36,507 = $524,593). (Stip. ¶ 23).

18. The petitioners were allowed to deduct $194,783 of their suspended ordinary losses (i.e., of the $488,086) in 1994 and the remainder (i.e., $293,303) was disallowed in the notice of deficiency. (Stip. ¶ 24).

19. The petitioners' $36,507 deduction attributable to suspended capital losses was also disallowed. (Stip. ¶ 25).

20. Absent the petitioners' $329,810 increase to stock basis (from the excluded income), the petitioners would not have had any stock basis to claim the disallowed losses of $293,303 and $36,507. (Stip. ¶ 26).

Experius Systems, Inc. ($16,216 adjustment)

21. The petitioners agree to the $16,216 adjustment attributable Experius Systems, Inc. (Stip. ¶ 27).

Capital Gains and Losses ($51,588 adjustment)

22. The $55,543 of disallowed losses (per Exhibit A to the notice of deficiency) are computed as follows:

Experius Corp (EIN: 73-1107554)

Suspended Capital Loss:	($13,576)
Allowed Loss:	6,762
Disallowed Capital Loss	6,814

EHCI (EIN: 36-3156614)

Disallowed Capital Loss (see above):	36,507

Long-Term Capital Loss Carryover from 1993 (per return):	12,222
TOTAL:	55,543

The adjustment of $51,588 is arrived at by subtracting certain capital losses claimed on the return. The computation is reflected on Exhibit A to the notice of deficiency. (Stip. ¶ 28).

23. The petitioners own 100% of Experius Corporation ("EC"). (Stip. ¶ 29).

24. At all relevant times, EC was an S corporation. (Stip. ¶ 31).

25. EC's primary activity involved investments. (Stip. ¶ 33).

26. As of 12/31/93, the petitioners had $16,455 of suspended capital losses (losses in excess of stock basis) in EC. (Stip. ¶ 34).

27. As of 12/31/93, the petitioners had a zero stock basis in EC. (Stip. ¶ 35).

28. In 1994, EC realized $13,576 of COD (forgiveness of indebtedness) income under the provisions of I.R.C. § 61(a)(12). (Stip. ¶ 36).

29. The petitioners reported $6,762 of the foregoing debt discharge income (as flow-through ordinary income). (Stip. ¶ 37).

30. EC excluded from income (and the petitioners did not report) $6,814 of the $13,576. (Stip. ¶ 38).

31. At the time EC realized the $13,576 of income, it was insolvent as to $6,814. (Stip. ¶ 39).

32. The petitioners claimed to have increased their stock basis by $13,576 in 1994 ($6,762 reported + $6,814 excluded). (Stip. ¶ 40).

33. The petitioners deducted $13,576 as a long-term capital loss in 1994. (Stip. ¶ 41).

34. Absent the petitioners' $6,814 increase to stock basis (from the excluded income), the petitioners would not have had any stock basis to claim the disallowed losses of $6,814. (Stip. ¶ 42).

35. The disallowed $12,222 relates to petitioners' involvement with St. Louis South Park, Inc. ("South Park"). (Stip. ¶ 43).

36. At all relevant times, the petitioners owned 33.33% of South Park. (Stip. ¶ 44).

37. At all relevant times, South Park was an S corporation. (Stip. ¶ 46).

38. South Park's primary activity involved the operation of a convalescent center. (Stip. ¶ 49).

39. South Park incurred substantial losses over the years, and became insolvent in 1993. (Stip. ¶ 50).

40. South Park ceased to carry on a business in 1993. (Stip. ¶ 51).

41. On 12/31/92, the petitioners had a zero stock basis in South Park. (Stip. ¶ 52).

42. The petitioners increased their stock basis in 1993 by $338,371. This amount was their pro rata share of COD income realized by South Park. (Stip. ¶ 53).

43. The foregoing $338,371 was excluded from gross income at the corporate level (and not reported by the petitioners). (Stip. ¶ 54).

44. Part of the $338,371 basis increase was utilized to deduct losses in 1993 and part (namely $12,222) was carried-over to 1994 by the petitioners and claimed as a long-term capital loss (from worthless stock). (Stip. ¶ 55).

45. Absent the petitioners' $338,371 increase to stock basis (from the excluded COD income), the petitioners would not have had any stock basis to claim the disallowed 1994 loss of $12,222 (referenced above). (Stip. ¶ 56).

ULTIMATE FINDINGS OF FACT

The respondent respectfully asks that the Court find the following ultimate facts:

46. The petitioners are not entitled to increase the basis of their stock in any of the S corporations at issue on account of the COD income excluded from the gross income of the S corporations.

47. Regarding EHCI, the petitioners are not entitled to deduct the disallowed suspended ordinary losses of $293,303 and the disallowed suspended capital losses of $36,507.

48. Regarding Experius Systems, Inc., the petitioners agree to the $16,261 adjustment. (Due to the agreement, facts germane to this issue will not be discussed below.)

49. Regarding EC, the petitioners are not entitled to deduct the disallowed suspended capital losses of $6,814.

50. Regarding South Park, the petitioners are not entitled to deduct the disallowed capital loss of $12,222.

POINTS RELIED UPON

Consistent with this Court's holding in *Nelson v. Commissioner*, 110 T.C. 114 (1998), *aff'd*, 182 F.3d 1152 (10th Cir. 1999), the petitioners are not entitled to increase the bases of their stock in EHCI, EC and South Park by the excluded COD income relative to each corporation.

I.R.C. § 108 and the relevant subchapter S provisions work together to properly keep the excluded COD income at the corporate level (thereby denying a stock basis increase). In this regard, it cannot be disputed Congress intended for the excluded income of an S corporation to remain at the corporate level, on a deferred basis, in order to properly apply the attribute reduction provisions under I.R.C. § 108. The subchapter S provisions confirm this result by not providing for the flow through of deferred income to the shareholders of an S corporation.

The tax deferred nature of the excluded income is established by the I.R.C., legislative history, case law, and the only logical interpretation of the I.R.C. § 108 and subchapter S provisions. First, the reduction in tax attributes in I.R.C. § 108(b) clearly operates so that excluded COD income of a taxpayer will eventually be taxed on a deferred basis (via the elimination of net operating losses, reduced basis in assets, etc.). Second, Congressional

intent to defer the income recognition cannot be more clear in the legislative history underlying I.R.C. § 108. Third, both this Court and the Supreme Court have recognized and held that excluded COD income is tax-deferred income. Finally, no basis increase is warranted for the excluded COD income under the subchapter S provisions because, unlike tax-exempt income, there will generally not be a distribution to the shareholders resulting from same (i.e., a basis increase is not needed to preserve a "tax-exempt" characterization).

To the extent the excluded COD income exceeds tax attributes that it reduces, it has no further tax consequences. Not only is this result mandated by a proper construction of the relevant I.R.C. provisions, the legislative history underlying I.R.C. § 108 makes it perfectly clear the excluded COD income "is disregarded, i.e., does not result in income or have other tax consequences."

Another reason the petitioners should not be allowed to increase the basis of their stock in the subject S corporations is because they have not made the requisite economic outlay.

A close look at the two cases which have held for the taxpayers on this issue (*United States v. Farley*, 202 F.3d 198 (3rd Cir. 2000) and *Hoque v. United States*, No. 99-302-KI (D. Ore. Jan. 3, 2000)) reveals either an improper focus as to the controlling I.R.C. provisions or a misunderstanding as to what tax-exempt income is and why it is specifically listed as an item of income under I.R.C. § 1366(a).

In the end, the petitioners unwarranted stock basis increase – (a) is clearly inappropriate under the applicable authority, (b) creates deductions for the very item intended to be eliminated (i.e., the suspended losses at issue), and (c) impermissibly converts a tax deferral mechanism into a tax reduction mechanism.

ARGUMENT

I. COD INCOME EXCLUDED FROM GROSS INCOME BY AN S CORPORATION DOES NOT PASS THROUGH TO THE SHAREHOLDERS OF THE S CORPORATION AS AN ITEM OF INCOME UNDER I.R.C. § 1366(A) (1) AND DOES NOT INCREASE THE CORPORATE STOCK BASIS UNDER I.R.C. § 1367.

This case involves an attempt by the petitioners to obtain unwarranted double tax benefits from the insolvency of their subchapter S corporations. As explained below, the anomalous result sought by the petitioners has been rejected by this Court, is contrary to the relevant Internal Revenue Code provisions and legislative history relating thereto, and simply does not make sense when considering the statutory schemes involved.

A. *Nelson v. Commissioner*, 110 T.C. 114 (1998), was correctly decided.

In *Nelson v. Commissioner*, 110 T.C. 114 (1998), *aff'd*, 182 F.3d 1152 (10th Cir. 1999), this Court correctly held that COD income excluded from gross income under I.R.C. § 108(a) does not pass through to the shareholder of an S corporation as an item of income under I.R.C.

§ 1366(a) (1) and, in turn, does not increase the basis of the shareholder's corporate stock under I.R.C. § 1367. In its well-reasoned opinion, this Court found support for its holding in the literal language of the applicable statutory provisions, in legislative history and in established case law. This Court has consistently followed its opinion in *Nelson*. *See, e.g., Winn v. Commissioner*, T.C. Memo. 1998-71; *Chesapeake Outdoor Enterprises, Inc. v. Commissioner*, T.C. Memo. 1998-175; *Friedman v. Commissioner*, T.C. Memo. 1998-196, *appeal docketed*, No. 98-2378 (6th Cir. December 17, 1998); *Gaudiano v. Commissioner*, T.C Memo. 1998-408, *appeal docketed*, No. 99-1294 (6th Cir. March 8, 1999); *Cronin v. Commissioner*, T.C. Memo. 1999-22, *appeal docketed*, No. 18408-99 (7th Cir. May 10, 1999); *Pugh v. Commissioner*, T.C. Memo. 1999-38, *appeal docketed*, No. 99-12646 (11th Cir. July 26, 1999); *Conviser v. Commissioner*, T.C. Memo. 1999-47; *Eberle v. Commissioenr*, T.C. Memo. 1999-287; *Goodman v. Commissioner*, T.C. Memo. 2000-21; *Mullen v. Commissioner*, T.C. Memo. 2000-23; *Bettisworth v. Commissioner*, T.C. Memo. 2000-30.

B. I.R.C. § 108 and the relevant Subchapter S provisions work together to properly keep the excluded COD income at the corporate level, thereby denying a stock bases increase.

In attempting to increase their stock bases in the various S corporations at issue, petitioners have misinterpreted the statutory frame work provided by I.R.C. §§ 61, 108, 1366 and 1367.

I.R.C. § 61(a) (12) provides that gross income includes income from the discharge of indebtedness.

I.R.C. § 108 provides exceptions to this general rule. As relevant here, I.R.C. § 108(a) (1) (B) provides that gross income does not include any amount which would be includable in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent. There is, however, a cost for the exclusion of COD income. Under I.R.C. § 108(b) (1), the amount so excluded from gross income must be applied to reduce certain tax attributes of the taxpayer. Unless the taxpayer elects to apply this reduction first against the basis of its depreciable property, I.R.C. § 108(b) (2) requires that taxpayers apply the excluded amount to reduce the following tax attributes in the following order:

> (A) *NOL.* – Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.
>
> (B) *General Business Credit.* – Any carryover to or from the taxable year of a discharge of an amount for purposes of determining the amount allowable as a credit under section 38. . . .
>
> (C) *Minimum Tax Credit.* – The amount of the minimum tax credit available under section 53 (b) as of the beginning of the taxable year immediately following the taxable year of the discharge.
>
> (D) *Capital Loss Carryovers.* – Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.
>
> (E) *Basis Reduction.* – * * * . The basis of the property of the taxpayer. * * * .

> (F) *Passive Activity Loss and Credit Carryovers.* – Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge.
>
> (G) *Foreign Tax Credit Carryovers.* – Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

I.R.C. § 108(b) (4) (A) provides that the reduction in tax attributes is made after the determination of the tax for the taxable year of the discharge.

Special rules for S corporations are contained in I.R.C. § 108(d) (7). First and foremost, I.R.C. § 108(d) (7) (A) provides that subsections (a), (b), (c), and (g) of I.R.C. § 108 shall be applied at the corporate level.[1] Also, for purposes of determining the appropriate net operating loss reduction under the attribute reduction provision, I.R.C. § 108(d) (7) (B) provides that any loss or deduction that is disallowed for the taxable year of the discharge under I.R.C. § 1366(d) (1) is treated as a net operating loss for such taxable year.[2]

When considering the provisions of I.R.C. § 108 discussed above, it cannot be disputed Congress intended for the excluded income of an S corporation to remain at

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[1] In contrast, I.R.C. § 108(d) (6) provides that these rules apply at the partner level in the case of a partnership.

[2] I.R.C. § 1366(d) (1) provides that losses and deductions taken into account by a shareholder of an S corporation for any taxable year cannot exceed the sum of the adjusted basis of the shareholder's stock in the S corporation plus the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder.

the corporate level in order to properly apply the attribute reduction provisions. The interpretation of I.R.C. § 108 proposed by the petitioners is plainly wrong. Under their approach, I.R.C. § 108 – (a) creates deductions for the very item it is intended to eliminate (i.e., losses suspended under I.R.C. § 1366(d) (1)), and (b) is converted from a tax deferral mechanism into a tax reduction mechanism. *See Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 575 (1982) ("[I]nterpretations of a statute which would produce absurd results are to be avoided if alternative interpretations consistent with the legislative purpose are available.").

As indicated below, the relevant subchapter S provisions operate to confirm and carry-out the statutory scheme dictated by I.R.C. § 108. In doing so, the integrity of the overall purpose and goal of subchapter S is maintained.

The subchapter S passthrough scheme features a system by which corporate income, losses, deductions, and credits are passed through to shareholders. Section 1366 implements the passthrough scheme by providing rules addressing the tax consequences to shareholders for income realized by, and losses incurred by, the corporation. Section 1366(a) (1) provides:

> In determining the tax . . . of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends . . . there shall be taken into account the shareholder's pro rata share of the corporation's –

> (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and
>
> (B) nonseparately computed income or loss.
>
> For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).

Pursuant to I.R.C. § 1366(a), the S corporation allocates pro-rata shares of income (including tax-exempt income) and loss (the separate treatment of which could affect the tax liability of any shareholder) and nonseparately computed income or loss to its shareholders, who take the items into account in determining their tax liability. Because the excluded COD income is tax deferred income, not tax-exempt, and the reduction of tax attributes occurs at the corporate level, the excluded COD income is not allocated to the shareholders to pass through to them under I.R.C. § 1366(a). However, the shareholders take into account any COD income that was subject to (i.e., exceeded) the insolvency limitation under I.R.C. § 108(a) (3) at the corporate level and passed through to them.

A shareholder's basis in the shareholder's stock, initially established through an actual economic outlay, is a measure of the shareholder's tax investment in the corporation. Subsequent adjustments to basis are made pursuant to I.R.C. § 1367. Section 1367(a) (1) provides for increases in the basis of a shareholder's stock in an S corporation as follows:

> The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:
>
> > (A) the items of income described in [section 1366(a) (1) (A)],
> >
> > (B) any nonseparately computed income determined under [section 1366(a) (1) (B)]. . . .

Section 1367(a) (2) provides for decreases in the basis of a shareholder's stock in an S corporation as follows:

> The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:
>
> > (A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,
> >
> > (B) the items of loss and deduction described in [section 1366(a) (1) (A)],
> >
> > (C) the nonseperately computed loss determined under [section 1366(a) (1) (B)]. . . .

Thus, each shareholder's pro rata share of income, including any non-excluded COD income subject to the limitation under I.R.C. § 108(a) (3) that passes through, increases each shareholder's stock basis for the taxable year of the discharge. In addition, each shareholder's pro rate share of losses that pass through, including any previously suspended losses discussed below, decrease

each shareholder's stock basis for the taxable year of the discharge.

Relative to losses, I.R.C. § 1366(d) (1) limits the aggregate amount of losses taken into account under I.R.C. § 1366(a) to the sum of the shareholder's adjusted basis in stock of the corporation plus adjusted basis in corporate debt owed to the shareholder. Losses disallowed under I.R.C. § 1366(d) (1) may be carried forward indefinitely and used when the shareholder increases the shareholder's basis in the corporation's stock or debt under I.R.C. § 1366(d) (2). Section 1366 (d) (2) provides that "[a]ny loss or deduction which is disallowed for any taxable year by reason of [I.R.C. § 1366(d) (1)] shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder." Therefore, the shareholders can take into account any previously suspended losses treated as incurred in the year of the discharge, limited under I.R.C.§ 1366(d) (1) to the extent of any increases in their bases pursuant to I.R.C. § 1367(a) (1). Any previously suspended losses taken into account by a shareholder under I.R.C. § 1366(a) (1) will cause a decrease to that shareholder's stock basis pursuant to I.R.C. § 1367(a) (2).

The pass through of income and losses under I.R.C. § 1366(a) and any resulting adjustments to basis under I.R.C. § 1367 are effected before the reduction of tax attributes at the corporate level by the excluded COD income, which does not pass through to the S corporation shareholders. Thus, shareholders are allowed either losses incurred in the year of the discharge or losses previously suspended to the extent of their existing basis

in the stock of the S corporation or increased basis due to income passed through in the year of the discharge.

When the foregoing provisions of I.R.C. § 108 and subchapter S are considered together, it is clear the Code does not permit the petitioners to increase their stock basis in EHCI, EC and South Park by the excluded COD income relative to each corporation. First, income excluded under I.R.C. § 108 does not pass through from an S corporation to its shareholders because, under the design of I.R.C. § 108 (including the attribute reduction provisions), any excluded COD income is tax deferred income, not tax-exempt income. Since the excluded COD income is tax deferred income, the statutory provisions applicable to S corporations do not permit the pass-through of the excluded COD income to the petitioners.[3] Indeed, quite the opposite is required. Second, excluded COD income does not pass through an S corporation to its shareholders because of the literal language of I.R.C. § 108(d) (7). While these results are clear from the authority discussed above, a couple of the key points are further explained below.

1. Excluded COD income is tax deferred income, not tax-exempt income, and does not pass through to the shareholders of an S corporation.

Under I.R.C. § 108, excluded COD income does not pass through from an S corporation to its shareholders

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[3] If the income were tax-exempt income, such a passthrough to the shareholder would be required under I.R.C. § 1366(a) (1).

because, under the design of I.R.C. § 108, excluded COD income is tax deferred income, not tax-exempt income. Consequently, the statutory provisions governing S corporations do not provide for the passthrough of the excluded COD income to the shareholders. Support for this position is found in the operation of I.R.C. § 108 and in its legislative history.

As discussed above, the cost of the I.R.C. § 108 exclusion from income is that the taxpayer must reduce certain tax attributes by the amount of the COD income excluded from gross income in the current year. *See also Nelson v. Commissioner*, 110 T.C. at 129. Unless the taxpayer elects to apply this reduction first against the basis of its depreciable property, I.R.C. § 108(b) requires that the taxpayer apply the excluded amount to reduce its attributes in the order provided in I.R.C. § 108(b). The ordering rules for the reduction in tax attributes in I.R.C. § 108(b) operate so that excluded COD income of a taxpayer will eventually be taxed (via the eliminated net operating losses, reduced basis in assets, etc.). Consequently, excluded COD income is not tax-exempt income. Rather, recognition (and taxation) of excluded COD income is merely deferred to a later date.

Legislative history to the Bankruptcy Tax Act of 1980 clearly indicates the exclusion from income provisions under I.R.C. § 108 are intended to simply avoid immediate tax consequences by deferring the tax consequences to a later date. In this regard, the Senate Report provides: "To preserve the debtor's 'fresh start' after bankruptcy, the bill provides that no income is recognized by reason of debt discharge in bankruptcy, so that a debtor coming out of bankruptcy . . . is not burdened with *immediate tax*

consequences." S. Rep. No. 1035, 96th Cong., 2d Sess. (1980), 1980-2 C.B. 620, 624 (emphasis added); *see also Nelson v. Commissioner*, 110 T.C. at 127. The Senate Report makes clear, however, the relevant provisions of I.R.C. § 108 (e.g., the attribute reduction provisions) are needed to ensure that the tax is only deferred and will eventually be paid:

> At the same time, in developing the rules of the bill, the committee recognized that the basis-reduction mechanism of present law fails to effectuate the *Congressional intent of deferring, but eventually collecting tax on, ordinary income realized from debt discharge.*
>
> Thus present law permits both solvent and insolvent taxpayers to apply the amount of their discharged debts to reduce the basis of non-depreciable assets which may never be sold, such as stock in a subsidiary corporation or the land on which the company operates its business, thereby avoiding completely, *rather than deferring*, the tax consequences of debt discharge. * * * .
>
> Accordingly, the rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge.

S. Rep. No. 1035, 96th Cong., 2d Sess. (1980), 1980-2 C.B. 620, 625 (emphasis added).

Case law relied upon by this Court in *Nelson* also supports the treatment of excluded COD income as tax deferred income, not tax-exempt income. In *United States v. Centennial Savings Bank*, 499 U.S. 573, 580 (1991), the

Supreme Court, in construing I.R.C. § 108, stated that "the effect of § 108 is not genuinely to exempt such income from taxation, but rather to defer the payment of the tax by reducing the taxpayer's annual depreciation deductions or by increasing the size of taxable gains upon ultimate disposition of the reduced-basis property." In its opinion, the Supreme Court repeatedly referred to the tax deferral mechanism in I.R.C. § 108. *See Centennial Savings Bank*, 499 U.S. at 582-83.

Because the income at issue was merely deferred, it is clearly not "tax-exempt income" which can pass through to a shareholder under I.R.C. § 1366. This notion was disposed of in the Court's *Nelson* opinion as follows:

> An exclusion that is subject to an offset (the tax attribute reductions) and may be subject to taxation in the future (that is, excluded from gross income *for the taxable year*) does not signify or indicate an item of income that is necessarily tax exempt on a permanent basis. In contrast, the language in section 103(a) expressly delineates that gross income does not include income derived from interest paid on any State or local bond. *See also Cotton States Fertilizer Co. v. Commissioner*, 28 T.C. 1169, 1172-1173 (1957) (discussion of "wholly exempt" from tax versus postponement of tax).

Nelson, 114 T.C. at 125 (emphasis in original).[4]

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[4] The Government's view is reflected in the preamble to Treas. Reg. § 1.1366-1(a)(2)(viii): " 'Tax-exempt income' does not include income from discharge of indebtedness excluded from income in all circumstances in which section 108 applies." I.R.B. 2000-2, T.D. 88-52 at 253.

The case cited in the foregoing excerpt, *Cotton States Fertilizer Co. v. Commissioner*, 28 T.C. 1169 (1957), involves the interplay of sections 24(a)(5), 112(f), and 113(a)(9) of the Internal Revenue Code of 1939 (predecessors of I.R.C. §§ 265 and 1033). In *Cotton States*, this Court held that the taxpayer, who had received insurance proceeds after two of its plants had been destroyed by fire, was entitled to deduct amounts paid to a firm of architects to recreate plans and specifications and to a contractor to estimate the replacement costs of the destroyed plants. In so holding, this Court rejected the Commissioner's arguments that the fire insurance proceeds were wholly exempt from income tax and that the payments to the architects and the contractor allocable to those proceeds were, therefore, nondeductible (the Commissioner relied on Treas. Reg. 111, § 29.24-4[5] for the proposition that exempt income is income which is not required to be included in gross income). Rather, this Court, observing that the taxpayer was required to decrease the basis of its new property by the amount of gain not recognized as income, concluded that the insurance proceeds were not wholly exempt from taxation. In this Court's opinion, the applicable code sections provided for the postponement (or deferral) of taxation. *Cotton States*, 28 T.C. at 1172. While *Cotton States* did not involve I.R.C. § 108, it does provide substantial support for the position that debt discharge income excluded under I.R.C. § 108(a) is tax deferred, not tax-exempt income.

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[5] The language of Treas. Reg. 111, § 29.24-4 is similar to the language in Treas. Reg. § 1.265-1(b).

"Tax-exempt income" is not defined in I.R.C. §§ 1366 and 1367. However, tax-exempt income implies permanency so that the income item is never subject to taxation. The reason tax-exempt income is included under I.R.C. § 1366(a) is simple. Without the specific inclusion under I.R.C. § 1366(a) (as a deemed flow-through item of income) there would not be a corresponding increase in basis under I.R.C. § 1367(a)(1) and, as a consequence, any subsequent distribution of the income to the S corporation's shareholders would effectively result in a taxable distribution under I.R.C. § 1368(b)(2). This would, in effect, cause the income to lose its "tax-exempt" status. *See Nelson*, 110 T.C. at 118. Conversely, no basis increase is warranted for excluded COD income because there will generally not be a distribution to the shareholders resulting from same and only a deferral of income not an exclusion is intended.

Given the authorities cited herein, a construction of I.R.C. §§ 1366(a)(1)(A) and 1367 that would allow an S corporation to pass through excluded COD income to its shareholders as tax-exempt, rather than tax deferred, income would not only nullify I.R.C. § 108(d)(7)(A), but it would also fly in the face of the Congressional intent in enacting the Bankruptcy Tax Act of 1980 and established case law. *See Nelson v. Commissioner*, 110 T.C. 114 (1998). Fortunately, the integrity of I.R.C. § 108 is maintained by the simple fact that the subchapter S provisions do not provide for tax deferred income to be passed through to the shareholders and increase the basis in their stock.

2. To the extent there are insufficient tax attributes to reduce, the excluded COD income has no further tax consequences.

The legislative history with respect to I.R.C. § 108 specifically indicates that any amount of COD income remaining after the attribute reductions "is disregarded, i.e., does not result in income or have other tax consequences." S. Rep. No. 1035, 96th Cong., 2d Sess. (1980), 1980-2 C.B. 620, 620-21, 626; *see also Nelson v. Commissioner*, 110 T.C. at 128. Hence, not only is it clear that the income used to reduce tax attributes does not pass through to the shareholders of an S corporation, it is also clear any "leftover" income can not have the "tax consequence" sought by petitioners (i.e., an increase in stock basis). Simply put, after the application of I.R.C. § 108(b) and the resulting reduction of tax attributes there are no "items of income," tax-exempt or otherwise, to which I.R.C. § 1366(a) may apply. This makes sense given that the passthrough under I.R.C. § 1366(a) precedes the tax attribute reduction under I.R.C. § 108(b). *See Nelson*, 110 T.C. at 128 ("[T]o the extent that COD income exceeds the tax attributes that are reduced, or if there are no attributes to reduce, such 'excess' income does not go through the corporate form to the subchapter S shareholders, pursuant to section 1366(a)(1)(A).").

3. The literal language of I.R.C. § 108(d)(7)(A) mandates that subsections (a) and (b) of I.R.C. § 108 apply at the S corporation level, not at the shareholder level.

The language of I.R.C. § 108(d)(7)(A) is unambiguous in requiring that subsections (a), (b), (c), and (g) of I.R.C. § 108 be applied at the corporate level of an S corporation. Consequently, an S corporation must apply the exclusion from income rules under I.R.C. § 108(a) at the corporate level, and it must apply the reduction in tax attribute rules under I.R.C. § 108(b) at the corporate level. In this manner, I.R.C. § 108(d)(7)(A) operates as an exception to the general pass through design applicable to S corporations and their shareholders. The Court's *Nelson* opinion provides a succinct explanation of this point:

> [I]t is well established that a specific statutory provision will override a general provision. Hence, we believe that section 108(d)(7)(A) regulates the treatment of excluded COD income in the context of the subchapter S regime (i.e., sections 1363(a), 1366(a), and 1367(a)). * * * .
>
> The literal language at issue here provides that the reduction in tax attributes applies at the corporate level. Sec. 108(d)(7)(A). We do not interpret section 108(d)(7)(A) in a narrow manner. Here, we construe the provision to mandate that insolvency is determined – and COD income is excluded from gross income of an S corporation under section 108(a) – at the *corporate* level.

Nelson v. Commissioner, 110 T.C. at 121 (citations omitted; emphasis in original).

The legislative history of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, reveals the intent to exclude the income at the corporate level and, thereby, avoid a premature basis increase. In that statute, Congress extended the section 108 exclusion to income from discharge of "qualified real property business indebtedness." *See* I.R.C. § 108(a)(1)(D). The amount excluded under I.R.C. § 108(a)(1)(D) is applied to reduce the basis of the depreciable real property of the taxpayer. I.R.C. § 108(c)(1)(A). The House Report explains the effect of the excluded income on a shareholder's basis in the stock of an S corporation as follows:

> In applying this provision to income from the discharge of indebtedness of an S corporation, the election is made by the S corporation (sec. 1363(c)), *and the exclusion and basis reduction are both made at the S corporation level* (sec. 108(d)(7)). *The shareholders' basis in their stock is not adjusted by the amount of debt discharge income that is excluded at the corporate level.* As a result of these rules, if an amount is excluded from the income of an S corporation under this provision, the income flowing through to the shareholders will be reduced (compared to what the shareholders' income would have been without the exclusion). Where the reduced basis in the corporation's depreciable property later results in additional income (or a smaller loss) to the corporation because of reduced depreciation or additional gain (or smaller loss) on disposition of the property, the additional income (or smaller loss) will flow through to the shareholders at that time, and will then result in a larger increase (or smaller reduction) in the shareholder's basis than if this provision had not previously

> applied. *Thus, the provision simply defers income to the shareholders.*

H.R. Rep. No. 103-111, 103rd Cong., 1st Sess. 624-625, 1993 U.S.C.C.A.N. 378, 855-856 (emphasis added).

The petitioners' contention that the excluded COD income flows through to the shareholders prior to any tax attribute reduction essentially nullifies I.R.C. § 108(d)(7)(A). By improperly flowing the "income" through to the shareholders prior to attribute reduction, the excluded COD income will *never* be available to reduce attributes "at the corporate level" as contemplated by I.R.C. § 108(d)(7)(A). The requisite attribute reduction can only take place if either – (a) the excluded COD income remains at the corporate level on a deferred basis, or (b) the attribute reduction takes place prior to the flow through of the excluded COD income. As indicated elsewhere in this brief, Congress specifically chose the former approach.

C. Petitioners are not entitled to increase the subject stock basis because there was no genuine economic outlay for this amount.

In its *Nelson* opinion, this Court mentioned the lack of economic outlay as another reason why the petitioner was not entitled to increase his stock basis:

> Here, petitioner has not borne an economic cost. On the contrary, it would appear that the economic cost was to others, the creditors of the corporation. Nor has petitioner made an economic outlay. Section 108 allows an insolvent S corporation to receive discharge of indebtedness income sheltered from immediate taxation to its

> shareholders. To permit petitioner to increase basis in the stock of the corporation on account of such tax-deferred income would produce a windfall to him.

Nelson, 110 T.C. at 128. The petitioners in this case also did not make an economic outlay for the stock basis they seek.

The petitioners did not contribute (or pay tax on for that matter) any of the amounts for which they seek an increase in stock basis. Rather, the petitioners contend they are entitled to increase the stock basis solely by reason of the excluded COD income. To allow such an increase in basis would be an abuse of the tax law, which requires that a shareholder make a genuine economic outlay to increase the basis in his or her stock.[6]

In order for a shareholder to increase the basis of his or her stock in an S corporation or in debt owned by the S corporation to him or her, the shareholder must make a genuine economic outlay. *Bergman v. United States*. 174 F.3d 928 (8th Cir. 1999); *Bolding v. Commissioner*, 117 F.3d 270 (5th Cir. 1997); *Uri v. Commissioner*, 949 F.2d 371, 373 (10th Cir. 1991); *Estate of Leavitt v. Commissioner*, 875 F.2d 420, 422 (4th Cir. 1989), *cert. denied*, 493 U.S. 958 (1989); *Hitchins v. Commissioner*, 103 T.C. 711, 715 (1994). An economic outlay can be accomplished only by the flow of

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[6] Under I.R.C. § 1366(d), the aggregate amount of losses and deductions which can be taken into account by an S corporation shareholder for any taxable year cannot exceed the sum of the adjusted basis of the shareholder's stock in the S corporation and the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder.

money or property from the shareholder to the corporation. This can be done by a contribution of cash or property to the corporation which increases the shareholder's basis in his stock, or by the shareholder loaning money or property to the corporation. The courts have strictly interpreted the requirement of a genuine economic outlay. *Id.* In this regard, *Estate of Leavitt* holds:

> To increase the basis in the stock of a subchapter S corporation, there must be an economic outlay on the part of the shareholder. A guarantee, in and of itself, cannot fulfill that requirement. The guarantee is merely a promise to pay in the future if certain unfortunate events should occur. At the present time, the appellants have experienced no such call as guarantors, have engaged in no economic outlay, and have suffered no cost.

Estate of Leavitt v. Commissioner, 875 F.2d 420, 422 (4th Cir. 1989).

In the instant case, petitioners ask for a basis increase in the stock of each of their S corporations at issue (EHCI, EC and South Park) even though they made no such economic outlay. To allow such a basis increase without an economic outlay by the petitioners would effectively allow the petitioners to erect a "tax shelter" using the subchapter S provisions. This was never intended by Congress, and the prevention of such a result was specifically provided for in the subchapter S provisions. *See Estate of Leavitt v. Commissioner*, 90 T.C. 206, 217 (1988) (case decided under former I.R.C. § 1374), *aff'd*, 875 F.2d 420 (4th Cir. 1989), *cert. denied*, 493 U.S. 958 (1989).

D. The timing of attribute reduction does not control the outcome of this case.

In addressing whether excluded COD income passes through to the shareholders of an S corporation as an item of income to increase their corporate stock basis, some court decisions have identified the timing of the tax attribute reduction pursuant to I.R.C. § 108(b)(4)(A) as determinative. The special rule of I.R.C. § 108(b)(4)(A) provides that the reduction of tax attributes occurs after the determination of tax imposed for the taxable year of the discharge. The focus of the court decisions has been on whether, under this special rule, the reduction occurs during the taxable year of the discharge, before the corporation passes through income or losses; or the year following the discharge, after the corporation has passed through income and losses, including the excluded COD income. The Tenth Circuit in *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999), *aff'g, Winn v. Commissioner*, T.C. Memo. 1998-71, and the Seventh Circuit in *Witzel v. Commissioner*, 200 F.3d 496 (7th Cir. 2000), aff'g, T.C. Memo. 1999-64, have concluded that pursuant to I.R.C. § 108(b)(4)(A), the excluded COD income is applied to reduce tax attributes at the corporate level during the taxable year of the discharge and before income and losses pass through from the S corporation to its shareholders. The Third Circuit in *Farley* has concluded that the provision requires that the reduction of tax attributes takes place after the taxable year of the discharge. Because the Third Circuit treated the excluded COD income as tax-exempt income, it passed through to shareholders to increase their stock basis for the taxable year of the discharge, thus allowing them to use suspended

losses that would otherwise be treated as a tax attribute to be reduced.

Taken together, the statutory provisions under I.R.C. § 108 relating to the tax attribute reduction are not clear as to the timing of that reduction. The section provides that the reduction takes place "after the determination of the tax imposed by this chapter for the taxable year of the discharge." Relevant to reducing the tax attributes of S corporations, I.R.C. § 108(b)(2)(A) requires an S corporation to apply the excluded amount to reduce first any NOL "for the taxable year of the discharge," and any NOL "carryover to such taxable year." Section 108(b)(2)(E) then requires the S corporation apply any remaining excluded amount to the basis of the property of the taxpayer pursuant to I.R.C. § 1017. Also invoking I.R.C. § 1017, I.R.C. § 108(b)(5) provides that the taxpayer may elect to apply any portion of the tax attribute reduction to the reduction under I.R.C. § 1017 of the basis of the depreciable property of the taxpayer. Section 1017 specifically provides that if the tax attribute reduced is the basis of the taxpayer's property, as opposed to an NOL, then such reduction of basis shall apply to any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs. At best, the language of 108(b)(4)(A) is not clear or free from ambiguity.

The Circuit Courts' focus on the special rule of I.R.C. § 108(b)(4)(A) is misplaced, however. The timing of the corporate-level tax attribute reduction is irrelevant to the issue of whether shareholders get to increase their stock bases for excluded COD income, because the excluded COD income is tax deferred income, not tax-exempt

income, and does not pass through to shareholders. Thus, whether the reduction of tax attributes occurs at the end of the taxable year of the discharge or the beginning of the year following, the excluded COD income never passes through to increase the bases in the petitioners' stock, but remains at the corporate level to apply against the corporation's tax attributes.

The language of 108(b)(4)(A) is subject to different interpretations (as evidenced from the several Circuit decisions) only if excluded COD income is allowed to pass through to the shareholders. Otherwise, I.R.C. § 108(b)(4)(A) merely ensures that the tax attribute reduction is the final step an S corporation takes relative to the tax items for the taxable year of the discharge, whichever year it occurs. As in this case, this allows a shareholder to utilize any basis created during the year of discharge.

The following demonstrates the irrelevance of the timing of the tax attribute reduction under I.R.C. § 108(b)(4)(A) to the issue in this case. For the taxable year of a discharge, an S corporation computes its taxable income at the end of the taxable year, but is not subject to taxes pursuant to I.R.C. § 1363(a). COD income that is considered income under I.R.C. § 61(a)(12) is excluded from gross income under I.R.C. § 108(a)(1)(B) if the S corporation is insolvent. Pursuant to I.R.C. § 108(d)(7)(A), the exclusion of COD income from gross income is applied at the corporate level, thus, the determination of insolvency is made at the corporate level, not the individual shareholder level. Besides its COD income, the corporation computes its other income and losses for the taxable year of the discharge. In computing its income, the corporation makes its corporate-level determination

of insolvency pursuant to I.R.C. 108(d)(7)(A), and excludes the COD income from its gross income under I.R.C. § 108(a)(1)(B), subject to the insolvency limitation under I.R.C. § 108(a)(3). Any COD income in excess of the limitation is not subject to the exclusion under I.R.C. § 108(a)(1)(B) and should be includible in the gross income of the S corporation, unless otherwise excludible.

I.R.C. § 1366(a) provides that certain items of income of an S corporation are passed through to the shareholders of the S corporation. As relevant here, I.R.C. § 1366(a)(1)(A) defines an S corporation's separately stated items as "items of income (including tax-exempt income), loss, deduction, or credits the separate treatment of which could affect the liability for tax of any shareholder." The character of the item is determined as if the item were realized directly from the source from which realized by the corporation, or incurred in the same manner as the corporation. I.R.C. § 1366(b). The excluded COD income is not allocated to the shareholders and passed through to them because it is tax deferred income, not tax-exempt income, and the reduction of tax attributes occurs at the corporate level. I.R.C. § 1367(a)(1) provides that a shareholder's basis in the stock of an S corporation is increased by, among other things, the passthrough items of income described in I.R.C. § 1366(a)(1)(A), including tax-exempt income.

In terms of the timing of attribute reduction relative to losses, I.R.C.§ 1366(d)(1) limits the aggregate amount of losses taken into account under I.R.C. § 1366(a) to the sum of the shareholder's adjusted basis in stock of the corporation plus adjusted basis in corporate debt owed to the shareholder. Losses that are disallowed under I.R.C.

§ 1366(d)(1) may be carried forward indefinitely and used when the shareholder increases the shareholder's basis in the corporation's stock or debt under I.R.C. § 1366(d)(2). Section 1366(d)(2) provides that "[a]ny loss or deduction which is disallowed for any taxable year by reason of [I.R.C. § 1366(d)(1)] shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder." Therefore, the shareholders can take into account any previously suspended losses treated as incurred in the year of the discharge, limited under I.R.C. § 1366(d)(1) to the extent of any increases in their bases pursuant to I.R.C. § 1367(a)(1). Any previously suspended losses taken into account by a shareholder under I.R.C. § 1366(a)(1) will cause a decrease to that shareholder's stock basis pursuant to I.R.C. § 1367(a)(2). The pass through of income and losses under I.R.C. § 1366(a) is effected before the reduction of tax attributes at the corporate level by the excluded COD income, which does not pass through to the S corporation shareholders. Thus, shareholders are allowed either losses incurred in the year of the discharge or losses previously suspended to the extent of their existing basis in the stock of the S corporation or increase basis due to income passed through in the year of the discharge.

Finally, the S corporation must determine, at the corporate level, its tax attributes, including any suspended losses of the shareholders treated as NOLs, to be reduced under I.R.C. § 108(b) by the excluded COD income. Section 108(d)(7)(B), a special rule establishing one type of tax attribute for S corporations, confirms that the reduction of tax attributes follows the pass through of income

and losses. Section 108(d)(7)(B) provides that for purposes of reducing the NOL tax attribute for S corporations, "any loss or deduction which is disallowed for the taxable of the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year." Under this provision, only losses that are disallowed for the taxable year of the discharge are treated as a corporate-level NOL. These losses could include not only those actually incurred in the year of the discharge, but also those previously suspended but treated as incurred in the year of the discharge, either of which may be disallowed under I.R.C. § 1366(d)(1) for the taxable year of the discharge. Only after an S corporation determines which losses are disallowed for the taxable year of the discharge can the S corporation establish its NOL tax attribute under I.R.C. § 108(d)(7)(B). Any losses of the shareholders in excess of their bases will be disallowed under § 1366(d)(1) and treated as a corporate level NOL under I.R.C. § 108(d)(7)(B). Pursuant to I.R.C. § 108(b)(2)(A), the S corporation first applies the excluded COD income to reduce this NOL tax attribute for the taxable year of the discharge. The S corporation then reduces its other tax attributes by the excluded COD income in the order prescribed under I.R.C. § 108(b)(2), assuming no election is made to first reduce basis in depreciable property.

By way of example, assume that an S corporation, with a sole shareholder, is financially distressed and has its debt discharged for the taxable year. The amount of the discharged debt for the taxable year equals $125. Assume further than the shareholder has a basis in his S corporation stock of $0 and $90 of suspended losses from previous taxable years. Moreover, the S corporation is

insolvent in the amount of $75. For the taxable year of the discharge, the S corporation has no other income or losses.

The S corporation first computes its income for the taxable year of the discharge. Under I.R.C. § 61(a)(12), the S corporation potentially has $125 of COD income. However, applying I.R.C. § 108(a)(1)(B) at the corporate level, the S corporation qualifies for the insolvency exclusion. Because of the limitation under I.R.C. § 108(a)(3), the S corporation limits its excluded COD income under I.R.C. § 108(a)(1)(B) to $75, and treats the remaining $50 as COD income. The S corporation then passes through the $50 of COD income to its shareholder under I.R.C. § 1366(a)(1), while the $75 of excluded COD income remains at the corporate level for the S corporation to apply against its tax attributes.

Pursuant to I.R.C. § 1366(a), the shareholder takes the $50 of passthrough COD income into account in determining his tax liability. Under I.R.C. § 1367(a)(1), the shareholder then increases the $0 basis in his S stock by the $50 of COD income, resulting in a new basis in his S corporation stock of $50. At the same time, the shareholder treats his $90 of previously suspended losses as incurred in the year of the discharge under I.R.C. § 1366(d)(2). Because the basis limitation under I.R.C. § 1366(d)(1) limits losses taken into account for the taxable year to the shareholder's basis in his stock, he may take into account only $50 of the previously suspended losses for the taxable year of the discharge. The remaining $40 of previously suspended losses are disallowed for the taxable year of the discharge.

Finally, the S corporation reduces its tax attributes by the excluded COD income at the corporate level. The shareholder's $40 of previously suspended losses that are disallowed for the taxable year of the discharge under I.R.C. § 1366(d)(1) are treated as a NOL of the corporation under I.R.C. § 108(d)(7)(B). The S corporation applies the $75 of excluded COD income to reduce this $40 corporate-level NOL tax attribute. The remaining $35 of excluded COD income is used by the S corporation to reduce its other tax attributes in the order prescribed under I.R.C. § 108(b)(2). Any remaining excluded COD income will have no further effect.

E. The authority relied upon by the petitioners in their Trial Memorandum is not helpful in resolving the issue.

While the respondent will have to wait until reciept of the petitioners' opening brief to fully understand their position, a couple of points raised in petitioners' Trial Memorandum warrant a brief discussion.

First, rather than addressing the merits of the *Nelson* opinion, the petitioners devote the bulk of their Trial Memorandum to the problems they perceive with the 10th Circuit's opinion in *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999), *aff'g, Winn v. Commissioner*, T.C. Memo. 1998-71.[7] The criticism is directed primarily at the

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[7] The petitioners' discussion of the *Nelson* opinion primarily relies upon false and unfounded assertions such as the following: "In truth and in fact, the real reason that the . . . tax Court held for the government in *Gitlitz* and

10th Circuit's analysis of the timing of attribute reduction under I.R.C. § 108(b)(4)(A):

> In reaching its conclusion in *Gitlitz*, the Tenth Circuit relied primarily upon a timing statute, § 108(b)(4)(A), and interpreted that statute to provide that attribute reduction occurs *during* the taxable year of debt discharge and prior to the required passthrough of all items of S corporation income.

(Trial Memo. for Petitioners, p. 7; emphasis in original). The petitioners' perceived problems with the 10th Circuit's opinion should not factor into the analysis in this case, at least at this juncture, as – (1) the analysis herein is in line with the *Nelson* opinion and does not rely on the 10th Circuit's timing rationale, and (2) the facts of this case do not indicate that the attribute reduction approach condoned by the 10th Circuit was even utilized by respondent.[8]

Recent case law in this area warrants further discussion. In *United States v. Farley*, 202 F.3d 198 (3rd Cir. 2000), taxpayers invested in two S corporations, SCI Acquisition, Inc. and CCI Camping Corporation. By the end of

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Nelson . . . was not that the statutory language compelled the position of the Commissioner, but rather because the court[ ] apparently feared that the taxpayer's position would result in a 'windfall'." (Trial Memo. for Petitioners, p. 13.

[8] As to the latter point, the agreed facts dealing with EHCI (Stip. ¶¶ 5-26) show that respondent clearly did not utilize all of the COD income (i.e., $530,666.86) to offset the petitioners' claimed losses (totaling $604,069), thereby entitling them to claim $73,402 of their suspended losses (as opposed to the $197,783 allowed due to ordinary income flow-through).

1987, the taxpayers' basis in the S corporations had been reduced to zero, because of loss passthroughs. From 1987 through 1992, the S corporations continued to incur losses, which were suspended. In 1992, the S corporations were insolvent and ceased to operate. Secured creditors of the S corporations foreclosed on the corporate assets and forgave any unsatisfied debts. This resulted in COD income to the S corporation which it excluded from its gross income. Taxpayers increased their bases by the excluded COD income, and received refunds from the Service. The Service subsequently filed suit to recover the erroneous refunds. The Third Circuit in *Farley* reversed the district court holding that COD income excluded by taxpayers' S corporations passed through to them and increased their basis in the stock, allowing the deduction of suspended losses.

In holding for the taxpayers, the Third Circuit concluded that excluded COD income is tax-exempt income, that passes through to shareholders and raises their stock basis, allowing them to offset suspended losses against this basis. The court construed section 108(b)(4)(A) to order that the taxpayer's tax attributes were reduced by section 108(b)(1) in the year following the year of discharge. The court rejected the government's contention that the income was tax deferred rather than tax-exempt and, thus, did not pass through at all (regardless of the timing), stating that all income, tax-exempt or otherwise, passes through to the shareholders of an S corporation under section 1366(a)(1)(A).[9]

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[9] A couple of the more obvious problems with the *Farley* analysis are – (1) it really doesn't focus on whether or not the

It is the Commissioner's position that, regardless of the timing of the tax attribute reduction, the excluded COD income does not pass through to increase the basis of the S corporation stock because it is tax deferred, not tax-exempt income. However, it is also the Commissioner's position that suspended losses may be offset (i.e., utilized) in the year of the discharge by basis not linked to excluded COD income.

Even if a case can be made that the plain language of the relevant I.R.C. provisions support the taxpayers in *Farley*, the respondent believes the Third Circuit court did not properly take into account the statutory construction interpretation set forth by the Ninth Circuit in *Albertson v. Commissioner*, 42 F.3d 537 (9th Cir. 1994), *cert. denied*, 516 U.S. 807 (1995). In *Albertson*, the Ninth Circuit stated:

> We may not adopt a plain language interpretation of a statutory provision that directly undercuts the clear purpose of the statute. In *Brooks v. Donovan*, 699 F.2d 1010 (9th Cir. 1983), we refused to adopt a plain language interpretation of a statute governing pension funds. We reasoned that the "court must look beyond the express language of a statute where a literal

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excluded income properly passes through to a shareholder; rather, it hinges its determination on the timing of attribute reduction ("If the reduction occurs after the pass through of COD income . . . then the shareholders of an S corporation can adjust their basis upward and deduct the otherwise undeductable loses."), and (2) it appears to equate the excluded income at issue with "tax-exempt income" ("Put simply, discharge of indebtedness income, if treated like tax-exempt interest, passes through to the shareholders of an S corporation and increases the shareholder's basis in the stock.").

> interpretation 'would thwart the purpose of the overall statutory scheme or lead to an absurd or futile result.' " . . . [T]he [Supreme] Court noted that "[w]hen [a given] meaning has led to absurd results . . . this Court has looked beyond the words to the purpose of the Act. Frequently, however, *even when the plain meaning did not produce absurd results but merely an unreasonable one 'plainly at variance with the policy of the legislation as a whole,' this Court has followed that purpose, rather than the literal words.*"

Id. at 545 (citation omitted; emphasis in original). The Ninth Circuit in *Albertson* also stated:

> [W]e take heed of the Supreme Court's instructions concerning the proper interpretation of the Internal Revenue Code when the plain language of the provisions leads to an unreasonable result and directly contradicts its underlying purpose: the provision "*must* be analyzed and construed within the framework of the Internal Revenue Code and against the background of the congressional purposes."

Id. at 546 (emphasis in original).

In addition, the rationale of the Seventh Circuit in *Witzel v. Commissioner*, 200 F.3d 496 (7th Cir. 2000), *aff'g*, T.C. Memo 1999-64, conflicts with both the Tenth Circuit's opinion in *Gitlitz* and the Third Circuit's opinion in *Farley* as well as the Tax Court's position in *Nelson* and its progeny. In *Witzel*, taxpayers were the sole shareholders of an S corporation that filed for bankruptcy in 1991. Through bankruptcy, the S corporation received $5.4 million in excluded COD income. Taxpayers increased their stock basis by the $5.4 million of excluded COD income

and deducted $2.5 million in suspended losses. The Commissioner disallowed the deduction, determining that the S corporation's excluded COD income could not increase taxpayers' stock basis. The Tax Court agreed. *Witzel v. Commissioner,* T.C. Memo. 1999-64. The Seventh Circuit concurred with the Tax Court that COD income reduces the taxpayers' tax attributes at the corporate level. In dicta, however, the court indicated that it disagreed both with the Tax Court's opinion in *Nelson* and the Supreme Court's analysis in *United States v. Centennial Savings Bank FSB,* 499 U.S. 573, 580 (1991), that excluded COD income is tax deferred, not tax-exempt income. Therefore, after the tax attribute reduction, excluded COD income may flow down to the taxpayer. This dicta conflicts with the Commissioner's position that excluded COD income is not tax-exempt and does not increase the basis of S corporation stock even after tax attributes have been offset. Application of the dicta in *Witzel* creates a windfall for taxpayers in subsequent years when they receive the benefit of increased basis from COD income.

Finally, in *Hogue v. United States,* No. 99-302-KI (D. Ore. Jan. 3, 2000), the district court held for the taxpayers on a similar section 108 issue. James Hogue owned 50 percent of the shares of Beaver Coaches, Inc., ("BCI"), an S corporation. The remaining 50 percent of BCI was owned by Frank and Linda Storch, the other plaintiffs in the suit. As the result of an involuntary bankruptcy petition filed against BCI (under Chapter 7 of the Bankruptcy Code, Title 11), BCI was relieved of debt in the amount of $1,849,923. This COD income was realized by BCI in 1994.

The district court held for the taxpayers stating that the COD income passed through to the shareholders

under I.R.C. § 1366(a)(1) and increased their basis under I.R.C. § 1367. The court further concluded that the tax attributes of BCI were decreased in 1995 pursuant to I.R.C. § 108(b). In so ruling, the district court disagreed with the analysis set forth by the Tenth Circuit in *Gitlitz*.[10]

In reaching its determination, the district court stated: "[A]lthough we should try to avoid double tax benefits, courts must leave them standing if the code positively requires this outcome." Thus, the district court appeared to recognize that the taxpayers were receiving a windfall.

We do not believe that the plain meaning of the statute causes the result asserted by the taxpayers and found by the district court. But even if a case could be made that the plain language did support the taxpayers and the district court, we believe that the above analysis of the statutory scheme and the legislative history clearly shows that Congress did not intend this result and that the taxpayers would receive a windfall that was not intended.

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[10] One of the primary problems in the District Court's determination that excluded COD income generates basis was the Court's unjustified reliance upon the following conclusion: "Once the COD income is excluded, it is treated as tax-exempt income for purposes of section 1366(a)(1) and is passed through under that section." As indicated earlier in this brief, the excluded income is clearly not "tax-exempt."

CONCLUSION

It follows that the determination of the Commissioner of Internal Revenue should be sustained.

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